NOTES

WASHINGTON NOTES

MEMBERSHIP OF STATE BANKS IN THE FEDERAL RESERVE SYSTEM

The Federal Reserve Board has prepared and issued regulations (*Circular No. 14,* 1915) relating to the membership of state banks in the federal reserve system. Provision is made for the entrance of state banks into the system at the Board's discretion, upon application, subject to various restrictions and conditions of examination. The two outstanding points in the circular are that it permits the withdrawal of state banks which may have become members, under specified conditions; and that it permits such state banks as become and continue members to exercise their statutory and charter rights after entrance into the system just as before. This means that they may continue to loan on real estate security without reference to the restrictions imposed upon such loans under the National Bank act, although the regulations provide that a state bank which becomes a member shall invest in such loans only to an extent which will not impair its liquid condition. The terms of the circular have been under consideration by the Board more or less continuously ever since the organization of the federal reserve banks, and are the outcome of many consultations with bankers and experts. Legal advice, also, has been sought in numerous quarters. The opinion of the Advisory Council of the federal reserve system was obtained at its recent meeting in Washington, and was unanimously to the effect that the privilege of withdrawal should be granted to state bank members, and that the making of loans on real estate security should be permitted to continue under reasonable conditions. This also has been the practically unanimous view of officers and directors of federal reserve banks whose opinion has been asked, as well as of others interested in the matter. The Board has, it is understood, had before it many legal opinions, including those of the counsel of various federal reserve banks, and these have been in favor of the position taken in the new circular and regulations. While the interpretation of the provision of the Federal Reserve act concerning membership of state banks offers considerable difficulty, it is believed that the plan now proposed complies with the requirements of the law.

The question whether the admission of state banks with power to continue their real estate loans, and with permission to withdraw, places them in a position of advantage which might subject the national banks to unduly severe competition, has been widely discussed, but it is thought that if such a danger exists, it can be largely avoided by exercising adequate care with reference to the admission of banks to membership. No banks will be admitted unless they are sufficiently strong and well managed to insure their being effective working members of the system, conducting their business upon a high plane, and observing all the requirements of sound management. While it is not intended to duplicate state examinations more than necessary, or to impose an undue burden of expense upon member banks, the Board's supervision is expected to be such as to insure the maintenance of stable and generally uniform conditions of competition among all the banks of the system, whether state or national. The circular and regulations provide for reliance upon state bank examinations to the fullest extent that is possible, and for the making of co-operative arrangements between state and national authorities with reference to such examinations. This will lessen the expense of overseeing the system, and will remove the possibility, which might otherwise exist, that state banks might be constantly under examination by various classes of examiners.

There has been no effort to forecast the number of banks that will probably enter the system in the near future under the provisions of the circular and regulations. The Board states in its circular that it is more concerned with the quality of the members than with their number; and it is prepared to see a slow, steady increase in the number of banks, each institution admitted being granted membership only upon satisfactory evidence that it will be a source of strength to the system.

It is probable that state bankers who have what to them seems good ground for postponing of action will continue to find reasons for delay for some time to come, and will not bestir themselves to join the system until a fresh motive is afforded to them for so doing. If the rediscount plan operates as it is expected to, state banks will get the benefit of it indirectly by finding themselves able to dispose of their paper on favorable terms in the open market without necessarily going to a federal reserve bank for accommodation. It is rather to be expected that the motive tending to lead state bankers to enter the system will be found in the clearing function. If the clearance provision in the Federal Reserve act proves successful, it may be expected that business will be transferred to the member banks by those who will appreciate the immense advantage open to them as a result of the provisions freeing

them from the conditions to which they have heretofore been subjected in regard to domestic exchange. It will be imperative for state banks to place themselves upon as good a foundation for appealing to the public in this regard as that upon which the member banks rest. The early entry of state banks into the system depends in a very large measure on the way in which the clearance feature is handled, and the extent to which the clearing function is developed by the federal reserve banks.

Another question of longer range, and of equally great moment, is this: Will the federal reserve system tend to enlarge the national system of banking, or to limit it? In other words, will the future of state institutions under the Federal Reserve act be a future of gradual conversion into national banks, or will the state institutions find their ranks gradually enlarging until ultimately the banking system of the United States consists of a body of banks organized under state law and federated together in twelve federal reserve institutions, the national banks being either extinct or on the road to extinction? In much of the banking discussion of the past two or three years, it has been stated that the drift of things was toward the elimination of the national bank. This was on the ground that with the bond basis for currency issue definitely removed there would be no particular reason why a national bank should exist; while with the privilege of membership in the federal reserve system open to state banks it would be largely a matter of indifference under which system an institution might organize. It would seem that there is good ground for believing that as a result of banking discussion, and largely in consequence of the unifying influence of the federal reserve system, there will be a much stronger drift than heretofore toward standardization of bank examinations and of banking legislation. The Federal Reserve act will have a very powerful influence in bringing about uniformity of conditions in examining banks and in controlling them generally. If such uniformity be rightly developed, it may be supposed that banks already holding either a state or a national charter will continue as they are now. It may turn out that, there being less variation of the conditions under which the two systems are operated, the choice whether to enter a state or national system will be of relatively trifling importance, so that banks will enter one or the other in very much the same ratio as at present, or perhaps in substantially proportionate numbers.

THE "FIVE PER CENT CASES"

An important decision in the cases involving the so-called 5 per cent rebate in favor of goods imported in American vessels, provided for in the Underwood Tariff law of 1913, has been handed down by the United

States Court of Customs (Treasury Decisions, June 10, 1915, No. 23). The decision is of particular interest because it makes plain that the so-called "most-favored-nation treaties," to which the United States, with a number of other nations, is a party, are to be literally interpreted, any rebates that may be granted to vessels of the United States and goods imported in them being likewise granted to vessels of these "most-favored nations" and goods imported therein.

These fourteen cases, commonly known as the "Five Per Cent Cases," involve the construction of certain paragraphs in section 4 of the tariff act of 1913 as follows:

B. That nothing in this act contained shall be so construed as to abrogate or in any manner impair or affect the provisions of the treaty of commercial reciprocity concluded between the United States and the Republic of Cuba on the eleventh day of December, nineteen hundred and two, or the provisions of the Act of Congress heretofore passed for the execution of the same, except as to the proviso of article eight of said treaty, which proviso is hereby abrogated and repealed.

J. Subsection 7. That a discount of 5 per centum on all duties imposed by this act shall be allowed on such goods, wares, and merchandise as shall be imported in vessels admitted to registration under the laws of the United States: *Provided*, That nothing in this subsection shall be so construed as to abrogate or in any manner impair or affect the provisions of any treaty concluded between the United States and any foreign nation.

Q. That on and after the day when this act shall go into effect all goods, wares, and merchandise previously imported for which no entry has been made, and all goods, wares, and merchandise previously entered without payment of duty and under bond for warehousing, transportation, or any other purpose for which no permit of delivery to the importer or his agent has been issued shall be subjected to the duties imposed by this act and to no other duty, upon the entry or withdrawal thereof: . . . .

Section 3 of the act in a subparagraph provides:

S. Any merchandise deposited in any public or private bonded warehouse may be withdrawn for consumption within three years from the date of original importation on payment of the duties and charges to which it may be subject by law at the time of such withdrawal. . . . .

Article I of the Cuban reciprocity treaty provides that all merchandise the product of the soil or industry of the respective parties which at the time of its negotiation was being imported into the other free of duty should continue to be so admitted into each country.

Article II provides that during the term of the treaty all merchandise not included in Article I

and being the product of the soil or industry of the Republic of Cuba imported into the United States shall be admitted at a reduction of 20 per cent of the rates of duty thereon, as provided by the tariff act of the United States approved July 24, 1897, or as may be provided by any tariff law of the United States subsequently enacted.

Article VIII provides that

the rates of duty herein granted by the United States to the Republic of Cuba are and shall continue during the term of this convention preferential in respect to all like imports from other countries, and, in return for said preferential rates of duty granted to the Republic of Cuba by the United States, it is agreed that the concession herein granted on the part of the said Republic of Cuba to the products of the United States shall likewise be, and shall continue, during the term of this convention, preferential in respect to all like imports from other countries.

Certain other treaties with some nine nations, the continuing existence of which was conceded at the hearings on the case, were outstanding and in force at the date of the enactment of the tariff law, each containing what is referred to as the "reciprocal commercial provision." A clause in the treaty between the United States and Italy is taken as an example of the treaties in question, and is as follows:

The high contracting parties agree that whatever kind of produce, manufactures, or merchandise of any foreign country can be from time to time lawfully imported into the United States, in their own vessels, may be also imported in Italian vessels; that no other or higher duties upon the tonnage of the vessel or her cargo shall be levied and collected, whether the importation be made in vessels of the one country or of the other; and, in like manner, that whatsoever kind of produce, manufactures, or merchandise of any foreign country can be from time to time lawfully imported into Italy in its own vessels may be also imported in vessels of the United States, and that no higher or other duties upon the tonnage of the vessel or her cargo shall be levied and collected, whether the importation be made in vessels of the one country or of the other; and they further agree that whatever may be lawfully exported and re-exported from the one country, in its own vessels, to any foreign country, may in like manner be exported or re-exported in the vessels of the other country, and the same bounties, duties, and drawbacks shall be allowed and collected, whether such exportation or re-exportation be made in vessels of the United States or of Italy.

The questions for decision raised in the cases are (*a*) whether or not section J, subsection 7, became operative when the tariff act of 1913 took

effect; (*b*) whether merchandise imported in vessels of United States registry was immediately entitled to the 5 per cent discount; (*c*) whether merchandise imported in the registered vessels of the "most-favored" nations was immediately entitled to the like discount; (*d*) whether merchandise entered in bond for warehousing before the act took effect, subsequently withdrawn and entered for consumption, was entitled to such discount; (*e*) whether merchandise imported from Cuba was entitled to the 20 per cent reduction provided in the Cuban treaty, and to the 5 per cent discount provided in section J, subsection 7.

After very elaborate consideration of the history and facts in the case and after a correspondingly complete review of the action of Congress in adopting the rebate provision in the Underwood Tariff law, the Court of Customs now reaches the following conclusions:

1. That the merchandise involved in these cases, imported in the registered vessels of the United States, is entitled to the 5 per cent discount as held by the Board of General Appraisers which first ruled on the case and whose decision is now affirmed by the Court of Customs.

2. That as to the merchandise imported in the registered vessels of the treaty nations, both that which was imported and entered for consumption subsequent to the taking effect of the tariff act of 1913, as well as that which was brought to American ports prior thereto and entered in bond for warehousing, subsequently withdrawn for consumption and duties paid, the 5 per cent discount must be allowed, and with respect to such merchandise the judgment of the Board of General Appraisers must be reversed.

3. That the merchandise imported in vessels of American registry before the tariff act of 1913 took effect which was entered in bond for warehousing, subsequently withdrawn and entered for consumption and duties paid, is entitled to the 5 per cent discount thereon, and the judgment of the Board of Appraisers with respect thereto must be reversed.

4. That merchandise from Cuba is entitled to the reduction of 20 per cent ad valorem provided by the Cuban treaty and the further discount of 5 per cent ad valorem from the amount so ascertained. As to such importations, the judgment of the Board of General Appraisers must be affirmed.

Refunds of duties already collected, if made in accordance with these provisions, will amount to from $15,000,000 to $20,000,000. The verdict, however, is of much greater importance in its international commercial significance than is indicated by the amounts of money involved.

THE STEEL CORPORATION DECISION

The action of the United States District Court for the District of New Jersey in the case of *United States of America* v. *The United States Steel Corporation and Others*, handed down by the court in question on June 3,[1] adds another to the series of important court decisions intended to interpret and illustrate the meaning of the Sherman law; and will rank with the decisions of the Supreme Court of the United States in the Tobacco and Oil cases. The suit in question was instituted during the Taft administration, and has been in course of prosecution for about three years. The present decision is a complete and thorough review of the immense mass of material relating to the steel industry, which has been collected by government bureaus, congressional committees, and court officers for several years past. In passing upon the great volume of data placed before it, the court states the questions at issue as follows:

First: Was the Steel Corporation, when this bill was filed in 1911, prejudicing the public interests by unduly restricting competition or unduly obstructing the course of the steel and iron trade between the states or with foreign nations? If this question be answered yes, the law was then being violated and an injunction should issue to restrain present and future violations.

Second: Did the Steel Corporation, when it was formed in 1901, either by the intent of those forming it, or by the inherent nature of that company's contemplated acts, prejudice the public interest by unduly restricting competition or unduly obstructing the course of the steel and iron trade, interstate or foreign? If this question be answered yes, then the law was violated and the Steel Corporation must be adjudged originally illegal. If illegal, it must be dissolved, because only thus can its inherent nature be prevented from continuing to work further violations of the statute. On the other hand, if these questions are negatived, then the Steel Corporation should not be dissolved, but permitted to pursue that usual course of trade, which it was the purpose of this statute to protect. It will thus be seen that this case is practically one of business facts.

The two questions thus put are taken up for careful analysis and two distinct classes of conclusions are arrived at by the majority and minority of the court, both, however, uniting in the opinion that the

[1] U.S. District Court for the District of N.J.; *U.S. of America*, v. *U.S. Steel Corporation:* Buffington, J.

application of the government for a dissolution order should be dismissed. In brief, the conclusion of the majority of the court is that, as to the defendants, it is apparent that the bill should be dismissed. Concerning the principal relief sought against the corporation and its subsidiaries, the opinion is expressed that the government has not made out a case that should be followed by a decree of dissolution, and that sufficient reasons have not been afforded to justify the court in awarding an injunction against the further continuance of the concern in its present form. The minority of the court reaches the conclusions that the organizers of the Steel Corporation (1) intended to create a monopoly and to restrain trade, and (2) combined with others and attempted to monopolize trade within the meaning of the Sherman act. Further it is held that the Steel Corporation itself (1) neither attempted nor possessed the power alone to do the unlawful things intended by its formation, but (2) unlawfully combined with others to restrain trade by controlling prices. For many reasons, the view is then arrived at that, whatever remedy there may be against the organizers of the corporation for acts violative of the statute, certainly in this proceeding a decree of dissolution cannot be awarded against the corporation for the unlawful intent, and the unsuccessful effort, of its organizers to violate the law. Upon the finding that a corporation in and of itself is not now and has never been a combination or monopoly in restraint of trade, no decree of dissolution could be entered against it. When it appears, however, that the corporation violated one of the provisions of the statute by combining with others to restrain trade, and that it possesses the power again to do the like unlawful acts in the future, relief is to be obtained, according to the minority of the court, through the injunctive processes which would ordinarily follow such a finding, but the minority believes that the protection will be sufficiently secured by having the court retain jurisdiction of the case for the purpose of restraining price-fixing methods, should such be resorted to in the future.

The court's decision, in both the majority and minority opinions, is thus positive and distinct in its findings that various methods were resorted to by the Steel Corporation and its affiliated concerns for the purpose of restraining and interfering with competition, but the opinion is clearly held that these efforts were not sufficiently successful to warrant the drastic action demanded by the government in its dissolution petition. The position taken by the court has, however, been somewhat hastily received by the business world as a defense of the Steel Corporation, with the result that renewed activity in various kinds of shares

was witnessed on the stock exchange immediately after the verdict was announced. A close reading of the opinion scarcely warrants the belief that a new attitude has been adopted by the courts in regard to the interpretation of the Sherman law, and strongly suggests to the non-partisan mind that the court's findings have been reached upon a basis of very close reasoning and analysis which may be reversed or altered in important particulars by the ultimate tribunal to which the case has now been appealed by the government. Should the verdict of the lower court be there sustained, there would even then apparently be no warrant for the view that the vitality of the Sherman law had been seriously impaired.

COMPETITION IN THE TOBACCO INDUSTRY

The Bureau of Corporations has issued Part III of its *Report on the Tobacco Industry*.[1] The report deals at great length with the purely economic side of the tobacco business, tracing the development of prices, costs, and profits with the utmost detail. The document is of particular interest because it is the first connected view, carefully prepared, of the effects of the dissolution decrees of the Supreme Court. It will be remembered that the combination (i.e., the American Tobacco Company and various of its affiliated concerns and stockholders) was proceeded against under the Sherman Anti-trust act, and in May, 1911, the Supreme Court declared it to be unlawful. The case was remanded to the Circuit Court to work out a plan of dissolution which should bring about results in harmony with the law.

Considering only that part of the business of the combination which related to the manufacture of tobacco in the United States, the features of the decree essential to state in this connection were substantially as follows: The American Snuff Company, which was an affiliated company, and itself a combination of the leading snuff-manufacturing companies in the United States, was separated from the control of the combination, and its business was divided into three parts, one of which remained with the American Snuff Company, while the other two were transferred to two new companies organized for that purpose; further, the R. J. Reynolds Tobacco Company, which was chiefly a manufacturer of plug and smoking tobacco, was detached from the control of the combination and re-established as an independent company. Most of the remaining business of the combination relating to the manufacture of tobacco in the United States was divided among three large companies.

[1] Part III, "Prices, Costs and Profits," Washington, 1915.

For this purpose two new companies were organized, namely, the P. Lorillard Company, and the Liggett & Myers Tobacco Company, to each of which was alloted a part of the property, while the remaining part was retained by the American Tobacco Company. The court imposed by injunction various restrictive conditions on future operations and relationships of the companies thus established and on the individual defendants in the case, in order to prevent a recrudescence of the combination.

The ownership of all the stock of the successor companies was placed in the hands of the same persons who had been stockholders in the combination. The preferred stock was given voting rights, which it did not have before. This reduced the voting power of the twenty-nine chief stockholders, defendants in the case, from about 56 per cent in the combination to about 35 per cent, on the average, in the successor companies.

The question how far the decree of dissolution of the combination in 1911 has succeeded in establishing effective competition between the various parts thereof is one of great public interest.

During the period of the combination's existence the percentage of the business enjoyed by the independents almost steadily dwindled. Since the dissolution their proportion of the business has increased in some branches and decreased in others, the most marked decrease being in cigarettes. Few of these smaller companies have shown increased prosperity since the dissolution, and those which have increased their business are generally the larger ones which are engaged in the production of a varied line of tobacco products. Certain small companies having an especially popular brand have also shown increased business and greater prosperity.

It was not practicable to obtain data as to prices, costs, and profits for all these smaller companies, but such data were secured from a large number, including almost all the important concerns. Compared with either the combination or the successor companies, the independents have, on the whole, made an exceedingly poor showing of profits, and since the dissolution this has been especially marked in navy plug and in Turkish cigarettes. On the other hand, in long-cut smoking they have done much better since the dissolution than in the years immediately preceding it. In scrap tobacco alone have their profits been greater than those of the combination or successor companies.

One of the principal causes of this unfavorable profit showing of the smaller companies has been a much higher ratio of manufacturing costs

to sales, not due to differences in leaf costs, but to higher expenses in other items of factory costs. The chief explanation of this fact is apparently found in their small-scale operations and less efficient organization.

The smaller companies have also been at a marked disadvantage, compared with the combination or the successor companies, with regard to the cost of distribution. Their selling costs were markedly higher in every branch. This disadvantage was partly offset by the fact that the expenditures for advertising were smaller in most branches. In the total expense of distribution, as well as in manufacturing cost, however, the smaller companies almost invariably show at a disadvantage when compared with the Combination or the successor companies. Comparing the cost of distribution of the smaller companies immediately before and after the dissolution, it may be noted that they have shown a considerable increase in both selling and advertising expenditures in a majority of branches, and this is the principal reason for their decreasing rate of profit.

In conclusion, the study of prices, costs, and profits in the tobacco industry, without taking into consideration other factors in the competitive situation, indicates that the decree of dissolution has resulted in forcing the successor companies to compete with one another for business in most branches of the industry, but has not affected wholesale or retail prices. The successor companies have also competed with the smaller tobacco concerns and, collectively, have won business from them in some branches and lost to them in others. As a consequence of competition the rate of profit of the successor companies has been reduced, although their rate of profit is still high. In general, this competition has seriously reduced the profits of the other companies.

This reduction in profit has not been caused by increased cost of manufacture, but by increased expenses of distribution and principally by the increase in expenditures for advertising. As the sale of tobacco products depends largely on the advertisement of brands, competition in the tobacco business necessarily increases advertising expenditure. In other words, for tobacco products, and it may be true also for other brand articles, the social cost of the system of competition is largely found in extraordinary advertising expense, and this would seem to be inevitable for brand articles so long as they have a proprietary character.